

European dark pools

How do you anticipate dark pool services developing in Europe?

By offering the ability to execute in size at improved execution prices, dark pools offer a fantastic value proposition and demand for such high-quality execution services will only increase. The rapid expansion of dark trading is a logical response to reduced trade sizes on the lit markets, driven by the widespread use of high-frequency trading and algorithmic strategies. The average trade size on a lit market in Europe has decreased steadily from EUR 50,000 to EUR 8,500. While public limit order books continue to serve the 'vanilla' segment of the market very efficiently, one size no longer fits all. Dark pools offer institutional investors many of the efficiencies of public limit order books, but without revealing their intentions to the open market.

Will dark pools proliferate in Europe as they have in the US?

Although the regulatory frameworks of Europe and the US are vastly different, there's every reason to expect the number of

One size no longer fits all

In this Q&A, Lee Hodgkinson, CEO, Smartpool, highlights the opportunities for buy-side traders to improve execution quality that arise from the rapid expansion of dark trading in Europe.



Lee Hodgkinson

European dark pools and their associated volumes to grow at the same rate as in the US. Institutional investors greatly value the ability to execute transactions immediately, anonymously and in size. The shift away from large-scale capital commitment to a more agency-style, technology-enabled approach will underpin growth in the dark pool space. As increased competition in the lit markets further depresses commission rates, dark pools will look increasingly attractive to market operators as alternative sources of revenue. As a result, we are likely to see a similar profile of growth to the US and, over time, many of the new entrants will be subject to attrition and consolidation. But this is a long game in which the combination of superior and sustainable economies of scale with entrepreneurship and agility will succeed.

How will increasing use of dark pools change European trading?

In many respects, dark trading has existed for many years in the form of upstairs markets. Dark pools provide sophisticated technology solutions to help improve and automate that process. They are a complementary service designed to meet the needs of a particular style of business and market segment, rather than a new form of trading that will replace traditional methods.

We are not likely to see a wholesale shift from public limit order books to dark trading venues. But dark venues will begin to encourage greater levels of block trading as the value proposition helps to unlock greater levels of liquidity directly from the buy-side to execution venues.

How will Europe's still-evolving regulatory framework impact dark pools?

As an exchange-led execution venue and a multilateral trading facility regulated by the Financial Services Authority (FSA), SmartPool holds itself to the highest standards of regulation.

Our business model is entirely consistent with MiFID's pre-trade transparency waivers. Furthermore, the fact that Smartpool has a minimum order size of EUR 10,000 not only guarantees that blocks can be found but also reduces the risk of gaming.

MiFID has led to an unprecedented level of change, as competition and innovation rapidly evolve. Though MiFID provides Europe with an overarching regulatory framework, interpretation is permitted at national level across all member states. As such, discrepancies exist. The Committee of European Securities Regulators (CESR) is working hard to harmonise MiFID's implementation and has made a number of welcome declarations on pre-trade transparency waivers, but substantial differences remain.

The MiFID review slated for 2010 is welcome and will need to address issues far broader than dark trading. For instance,

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fragmentation of post-trade data needs to be considered with the utmost urgency. In the interim, enforcement of the existing directive is as important as its amendment and improvement. We will of course support CESR, the FSA and the Commission in their ongoing work.

How should buy-side firms differentiate between dark pools?

In some respects, fund managers are less concerned about the details of dark pool offerings. It's all about liquidity and ultimately, they want timely, cost effective and high-quality execution in size. Until a venue establishes its ability to provide consistent high-quality liquidity, the buy-side will be wary. As venues generate higher volumes, only then can they expect the buy-side to integrate them into their execution processes.

Establishing a non-homogenous pool is critical. While the large investment

banks are vital in building a liquid dark venue, bringing together different flows from the widest and deepest possible set of relationships will be a major differentiating factor.

What value can dark pools add in the pan-European mid-cap space?

The implicit costs of trading, such as market impact, are much greater in securities where liquidity is scarce. As one moves into securities that have wider spreads and thinner liquidity, the dark trading proposition becomes even more attractive because there is a greater chance of finding orders in size without alerting the market to your intentions. Trading in the dark provides an opportunity to get the order filled without disclosing your interest to the wider audience. ■

